

# §1031 EXCHANGES

INSTRUCTOR

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- Please be aware that this information is intended to provide basic information about tax deferred exchanges, and is not intended to be complete legal or financial advice.

# Curriculum material to be covered

- Qualifying properties (30 minutes)
- Overview of the process (1 hour)
- WB-35 Simultaneous Exchange Agreement
- Basic Tax principles (30 minutes)
  - Gross income
  - Realization
  - Adjusted basis
  - Recognition of gain
  - Time value of Money
  - Capital gain
  - Types of exchanges and overview (1 hour)
    - Simultaneous like-kind exchange
    - Deferred exchange (Starker)

# Taxes!

- Generally, all gain on the sale of real estate is taxable, unless specifically exempted by law.

# Payment of Taxes

- April 15<sup>th</sup> for individuals and partnerships
- March 15<sup>th</sup> for corporations
- Example: An individual sells a parcel of land in July, when that individual files taxes next April they must report the sale and pay applicable capital gains tax.

## Very Basic Calculation of Capital Gains Tax

Original Purchase Price	\$100,000
Sale Price	\$150,000
	<hr/>
Taxable Gain	\$ 50,000

# Capital Gain vs. Equity

- ❑ Capital gain is the difference between the amount realized on the sale of property and the adjusted basis.
- ❑ Equity is the difference between the market value of the property and all financing and debts encumbering the property.
- ❑ Capital gains tax is based on capital gains not on equity. This is commonly misunderstood.

# Capital gains calculator (simplification)

## Calculate Adjusted Basis

Original Basis (purchase price)	\$100,000
Plus Capital Improvements	0
Minus Depreciation (improvements only; not available for land)	\$20,000
	<hr/>
Adjusted Basis	\$80,000

# Tax Consequences – continued

## Determine Capital Gain

Sales Price	\$150,000
<i>Minus</i> transaction costs	0
<i>Minus</i> Adjusted Basis	\$80,000
<b>GAIN</b>	<hr/> \$70,000

(\$50,000 appreciation)  
(\$20,000 depreciation)

# Tax Consequences - continued

Capital gain from depreciation     \$20,000

Depreciation unrecapture Tax     25%                             \$5,000

Capital gain from appreciation     \$50,000

Federal Capital Gain Tax             15%                             \$7,500

Total             Federal Tax                             \$12,500

                           State Tax                             \$ 1,890

\*doesn't account for AMT, change in deductions

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\$14,390

# Realized vs. Recognized gain

- Gain is realized upon the sale of property. Only upon the sale of property is a seller required to account for the value or gain in that property. Prior to the sale any increase in value of the property is not realized by the seller. In effect, the gain is now determined and can be calculated.
- Recognized gain is that portion of the realized gain that a seller must include in his/her gross income for the year of the sale.
- Completing a 1031 exchange decreases the amount of gain recognized

Two major sections in the IRS code allow sellers to avoid paying capital gains tax (gain is not recognized) upon the sale of real estate in the year of the sale (§ 1033 applies to involuntary conversions such as condemnations) and they are:

- § 121
- § 1031

# §121 vs. § 1031 compare and contrast

§ 121 Sale of Residence – Section 121 of the treasury code allows individuals to avoid the payment of capital gains tax on the sale of their primary residence. The following requirements and limitations apply:

- During the preceding 5 years, you must:
  - Own the property at least 2 years
  - Live there as your primary residence at least 2 years
- If qualified, you:
  - Exclude up to \$250,000 in gain, or \$500,000 for married couple
  - Do not report sale on Form 1040
  - Available once every two years
- Vacation homes and second homes DO NOT QUALIFY
- If used as rental and primary residence, depreciation taken after 5/7/97 must be recognized
- Non-qualifying use after 1/1/09
- EFFECTIVE 10/22/04: If property was acquired in a §1031 exchange, and later converted to personal use, taxpayer must hold for a minimum of FIVE YEARS before taking §121 exemption.
- Elimination of tax

# § 1031

- “No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held for productive use in a trade or business or for investment.”
- §1031 provides for deferral of taxes, not complete elimination. The unrecognized gain passes to and is reflected in the basis of the replacement property

# Why look into doing an exchange?

- Deferring tax payment allows funds to keep working for you.
- Who can take advantage of an exchange?
  - Any taxpaying individual or entity
- Some examples:
  - Business relocation
  - Owner retiring
  - Owner moving
  - Investor looking to change investment due to market forces
  - Owner wants out of Landlord headaches (TICs)

# “Like-Kind” Requirement

One of the largest myths in 1031 exchanges of real estate

# Qualifying Properties

## “Business or Investment Use”

### YES

- ❑ **trade or business;**
- ❑ **investment use** (ie rental)

### NO

- ❑ **personal use** (typically personal residence) including property used solely as a vacation home / second home;
- ❑ **primarily for sale.** IRS uses the term Dealer (Developer). A dealer can have investment property if segregated from inventory

# Dealer Property

- A dealer is a person who holds property primarily for sale in its ordinary course of business (inventory)
- Factor based test:
  - Frequency, number and regularity of real estate sales.
  - Percentage of income from sale of property.
  - Development activity:
    - subdividing, rezoning, grading, adding streets, etc.
  - Nature and extent of efforts to sell the property:
    - Use of advertising, use of business office to handle sales, sales personnel employed, extent of control over sales activities
- A dealer can sell property that is not held as inventory, but held as a capital asset for investment purposes.

# Vacation Homes

- The issue that arises with vacation homes is a question of “held for investment purposes.”
- 2007 federal tax case exploring the issue determined that investment intent not enough to qualify.
- 2008 revenue procedure – Does qualify if:
  - Own and hold property for 2 years
  - 14 day test –rent more/personal use less (or 10%)
  - Reasonable maintenance days are ok
  - Still leaves open issues such as:
    - No rental
    - Own less than 2 years

# Flippers

- ❑ Section 1031 has a “held for” element which is a questions of intent.
- ❑ Applies to both relinquished and replacement
- ❑ A prearranged plan to sell the acquired property shortly after the exchange has proved fatal in several cases.
- ❑ If the taxpayer has entered into a contract before the exchange to sell the target property after the exchange, the target property is likely not held for investment or in the trade or business.

## Less than fee interests in real property that qualify for exchanges:

- ❑ Leases with at least 30 years remaining, including renewal options.
- ❑ Vendee's interest in a land sale contract (Contract for deed); not the Vendor's interest.
- ❑ Undivided interest in one property for an undivided or 100% interest in another property.
- ❑ Remainder interest in real property.
- ❑ Timber rights, riparian rights, mineral rights.
- ❑ Interest in a Delaware Statutory Trust

# Section 1031 Exclusions

- The following is property that does not qualify under the treasury code for a section 1031 exchange:
  - Stocks, bonds or notes.
  - Other securities or evidences of indebtedness.
  - Certificates of Trust or beneficial interests.
  - Choses in action.
  - Goodwill, or “going concern” value.
  - Partnership Interests.

# Tax deferral in a Nutshell

- *To obtain complete deferral of capital gains taxes, the taxpayer must:*
  - Purchase replacement property that is:
    - (1) equal or greater in value to the relinquished property (no cash or mortgage boot) **AND**
    - (2) use all cash proceeds from the sale of the relinquished property (no cash boot)

**DON'T CONFUSE GAIN WITH EQUITY**

# History of Exchanges

- The history of exchanges began in 1921 with the allowance of tax deferral for direct swap type exchanges.
- The rationale for allowing non payment of tax is that there was no cash out of transaction to pay tax
- Tax code and case law (Starker) developed today's delayed exchanges in the 1980's and 1990's

# Types of Exchanges

- Simultaneous/ Direct Swap
- Straight deferred (most typical)(aka Starker Exchange)
- Build to suit
- Reverse (parked)

# Direct swap or simultaneous exchange

- ❑ In a direct swap exchange the 2 parties directly deed property to each other.
- ❑ Section 1031 is a mandatory section of the treasury code.
- ❑ WB-35 Simultaneous Exchange Agreement

# Straight Forward 1031 Exchange

- Most typical
- Sale of Relinquished Property
- Purchase of Replacement Property
- All within the time periods required

# Receipt of cash

**“DON’T Show Me the Money !!”**

- The exchange rules require that not only does the Taxpayer have to avoid receiving actual cash, but he must also *avoid constructive receipt* of cash. Thus, the Taxpayer must have *no control over any of the exchange “cash” from the relinquished property sale.* “g(6)”

## Other Prohibitions on the Exchange Funds

- Taxpayer cannot . . .
  - Pledge, assign, or otherwise promise the Exchange funds to a third party, such as a lender.
  - Direct that payments to third parties or to Taxpayer be made by the QI holding the funds.
  - Direct the QI to make an **earnest money** payment to the Seller of the Replacement Property from the exchange proceeds, UNLESS the Purchase Agreement between Taxpayer and Seller has been assigned to the QI.

# Expenses paid on Closing Statements

- Relinquished Property
  - Disallowed expenses are considered an amount paid out of the proceeds (exchange funds) and are considered boot.
  
- Replacement Property
  - Disallowed expenses are considered amount paid out of exchange funds coming into the closing and are considered boot.

# Allowed Exchange Expenses

Real estate commissions

Title insurance premiums

Closing or escrow fees

Legal fees

Transfer taxes and Notary fees

Recording fees

# Disallowed Exchange Expenses

Mortgage points and assumption fees

Credit reports

Lender's title insurance

Prorated mortgage insurance

Loan fees and loan application fees

Property taxes

Utility charges

Association fees

Hazard insurance

Credits for lease deposits

Prepaid rents and security deposits

# Qualified Intermediary

## 2 roles

- Hold exchange funds (security of funds)
- Party with whom the taxpayer exchanges (documentation calls for assignment of purchase agreement)

# Qualified Intermediary defined

## ■ QI is

- Not the taxpayer or other disqualified person
- Party to a written “exchange agreement” with taxpayer which restricts taxpayer receipt and control of exchange funds and transfers (directs) the Relinquished and Replacement Properties

## ■ Disqualified person

- Is an agent of the taxpayer, related party to taxpayer or related party to agent (employee, attorney, accountant, investment banker, real estate broker or agent; or has been within past two years)(parent, spouse, child, sibling, >10% owned business)
- Not disqualified if provide routine financial, title insurance, escrow or trust services.

# Process- Forward 1031 Exchange

1. **TAX ADVISOR:** The taxpayer (the individual or business selling property) should consult with a tax advisor to determine if a tax deferred exchange is appropriate and is compatible with overall investment goals.
2. **CONTACT INTERMEDIARY:** The taxpayer contacts intermediary once a closing is scheduled on the relinquished property to open a file and prepare exchange documents such as the exchange agreement.
3. **CLOSING ON THE RELINQUISHED PROPERTY:** At or before closing of the relinquished property the taxpayer working with the title company closer will sign the exchange agreement and proceeds will be delivered to the intermediary. A taxpayer must not close on the relinquished property without having an exchange agreement in place.

# Forward 1031 Process Continued

4. **IDENTIFICATION DEADLINE:** Within 45 days (calendar days) of the closing of the relinquished property, the taxpayer notifies the intermediary in writing (forms provided), of the identified replacement property(ies).
5. **CONTACT INTERMEDIARY:** The taxpayer contacts the intermediary when a closing on the replacement property(ies) is scheduled.
6. **ACQUISITION DEADLINE:** The taxpayer closes on the replacement property(ies) within 180 days (or less if the due date of the taxpayers tax return falls within the 180 days unless an extension is filed) from the closing on the relinquished property. Be careful NOT to use 6 months.
7. **ENJOY:** The taxpayer files their tax return as usual and enjoys the benefits of tax deferral.

# Identification Rules (fulfill one)

- 3 Property Rule – up to 3 properties, without regard to FMV;  
*or*
- 200% Rule – any number of properties, so long as aggregate FMV does not exceed 200% of FMV of relinquished properties; 2 times rule  
*or*
- 95% Rule – if first two rules violated, must acquire 95% of FMV of all identified properties. Buy all rule.

# Identification Requirements

- Signed and in writing
- Within 45 days sent to
  - QI or seller of replacement property
- Unambiguously describe property
  - Legal description
  - Street address
  - Distinguishable name (e.g., Mayfair Apartment Building)
- May be revoked or amended, with same formality as above
- Properties may be identified in the alternative

## Limitations on return of funds g(6) after exchange started

- Day 46 determines when funds can be returned to taxpayer. The idea is that the funds can be returned when there is no possibility of the exchange continuing.
  - If no properties identified then on day 46;
  - If properties are identified, when:
    - All identified are purchased;
    - End of 180 exchange period;
    - Substantial and material contingency beyond the taxpayers control exists (very gray area).
  
- Applies to cash back at closing of replacement property

# Reverse (parked) exchange

## Revenue Procedure 2000-37(safe harbor)

- Taxpayer cannot own both properties at the same time;
- Process still forward exchange for Exchangor;
- 45 and 180 day restrictions apply; total exchange period cannot exceed 180 days
- “Exchange Accommodation Titleholder” (EAT) must hold title to either relinquished or replacement properties
- Taxpayer must have ability to finance the “park.”

□ A few issues that typically arise

# Failed Exchange Taxation

- ❑ Exchange funds disbursed due to a cancelled or failed exchange can be taxed under section 453 (installment method) in the year received.
- ❑ Taxpayer does not have the right to obtain, access or receive the benefit of the funds until the year the exchange fails and funds are allowed to be disbursed.
- ❑ Taxpayer must have good faith intent to complete exchange.

# Seller financing

- Seller financing occurs when the seller of a piece of property through a note and mortgage or a Land Contract.
- Typically reported under section 453 and gain is taxed as received during the term of the note with the exception of depreciation recapture which is due in the year of sale.
- Relinquished Property
  - Land Contract is a sale at the time entered, not when deed passes (per state law)
  - IRS views as “installment payment” and is boot
  - Can be taxed on installment method as cash received
  - Recapture depreciation due in year of sale
  - For tax deferral can include note in exchange and dispose of note/LC within the 180 days. Can arrange with QI to turn into cash.
- Replacement property
  - Same as mortgage financing

# Combining §121 and §1031

- When property is both primary residence and business use. Example; farm, house with business, duplex
- Relinquished property
  - If business entirely within the home a taxpayer can use §121 only. Will have depreciation recapture if any.
  - If separate use both §121 and §1031 with an allocation on the closing statement or 2 statements.
  - Allocate by past depreciation deduction calculation or other reasonable and supportable method. Example; square footage, acres, appraisal, real estate tax statement.

# Multiple property exchange

- ❑ Taxpayer can sell multiple properties, to consolidate into fewer properties.
- ❑ Taxpayer can sell one property to diversify into many properties.
- ❑ Identification period – all replacement properties must be identified within 45 days of transfer of first relinquished property.
- ❑ Exchange period – all replacement properties must be acquired within 180 days of transfer of first relinquished property (or less).

# Same Taxpayer Requirement

- ❑ The IRS has required the taxpayer to go in and out of the exchange as the same taxpayer or entity .
- ❑ Who's tax return owns the property?
- ❑ Partnerships
  - ❑ example drop and swap
- ❑ Partial interests
  - ❑ Husband to husband and wife or vice versa

## □ Exceptions

- *Single Member Entities* – Exchangor can acquire replacement property in a single-member LLC. This entity is disregarded for tax purposes.
- *Grantor Trust* – Trustee takes title as an individual, then transfers to the Trust. Trust is disregarded for tax purposes.
- Under Rev. Proc. 2002-69, if a husband and wife are the only members of an LLC in a community property state (such as Wisconsin) that LLC can still be considered a “single member” disregarded LLC for tax purposes.
- *Death of Exchangor* – Exchangor dies during the exchange period, estate can complete the exchange.

# Related Parties

- The IRS has challenged the validity of certain 1031 exchanges that occurred between related parties.
- Definition of related parties for 1031 exchange purposes:
  - Exchangor's spouse, siblings, descendants or ancestors
  - Two corporations that are members of the same controlled group
  - Grantor or fiduciary of any Trust
  - Related C corporation, S corporation, or partnership in which there is more than 50% ownership or controlling interest

# Related Parties

- Sec. 1031(f) designed to prevent “basis shifting.”
- SWAP between related parties:
  - Related parties can complete an exchange if both parties hold onto the property that they received for a minimum of 2 years. If either party disposes of their property within the 2 year holding period, the entire transaction is taxable.

# Related Parties

- Sell relinquished property to a related party:
  - Gain *will be recognized* if the taxpayer disposes of relinquished property to a related party and the related party disposes of the relinquished property within 2 years. Rule diluted in 2007 and 2008 due to various tax court cases.
  - Except :
    - Transfer due to death or involuntary conversion of either party.
    - Transfers where there is no tax avoidance intent.
- Purchase replacement property from related party:
  - Gain *will be recognized* if the taxpayer buys replacement property from a related party unless the related party also does an exchange.

# Purchase agreements

- Taxpayers are free to enter into purchase agreements on replacement property at any time.
- Typical language inserted into a purchase agreement reads as (relinquished property version):
  - **“Buyer acknowledges that Seller intends to complete a §1031 tax-deferred exchange, and that Seller’s rights and obligations under this agreement may be assigned to an intermediary for the purpose of facilitating that exchange. Buyer agrees to cooperate with Seller to permit Seller to effect the exchange and execute such documents as Seller may reasonably request, provided such documents do not impose additional cost or liability to the Buyer.”**

# Refinancing

- “step transaction” doctrine
- There is no specific period of time in which a taxpayer may refinance before or after an exchange.
- If a liability has an “independent economic significance” for the placement of the new financing then it may pass muster with the IRS such as
  - A refinance that had been in the works before the exchange was anticipated
- It is generally accepted that a refinance on the replacement property after concluding an exchange is considerably less risky than refinancing the relinquished property prior to an exchange.

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